

Top 7 IFRS Mistakes

That You Should Avoid

**Learn how to avoid these mistakes so you won't be penalized
or create an accounting scandal at your company.**

Silvia of IFRSbox.com



Why Top 7 Mistakes That You Should Avoid?

If you have ever needed to prepare IFRS financial statements, I'm sure that they are exposed to many external users. Stock exchange, financing institutions, maybe some professional accountancy bodies, investors, shareholders, tax offices – just name it.

And your auditors!

In order to make all these people happy, your IFRS financial statements should be error-free – otherwise you're at risk of various consequences from a warning through large penalties.

I know you want to avoid an accounting scandal otherwise you wouldn't be reading this guide.

In this report I have summarized top 7 most common mistakes that companies make in their IFRS financial statements – yet they are so easy to avoid!

After reading this report, please check your own financial statements to make sure that you avoid these mistakes.

Enjoy!

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P.S. I would love to hear what you think of this report. Please email me at silvia.mahutova@ifrsbox.com.

Mistake #1

Ignoring substance over form principle

IFRS place high importance to substance over form in order to prohibit off-balance sheet financing, to prevent hiding of liabilities or losses and to avoid big accounting scandals like Enron or WorldCom.

What is it?

Substance over form means that we need to account for the transaction in line with its **economic substance** and not merely in line with its **legal form**.

In most cases, these two are the same.

But sometimes this is not true. Sometimes, the transaction is called “lease of an asset”, but in fact, the company buys the asset and funds this purchase with loan.

However, if a company does not account for liabilities from finance lease in full, readers of financial statements will never assess company’s liquidity and other indicators correctly – just because big finance lease liabilities are hidden.

Not even mentioning that regulators can penalize you hard for ignoring substance over form.

How to avoid this mistake:

Always review newly arranged contracts for the transactions whose economic substance might be different from their economic form.

Examples of such situations are:

- Finance lease contracts

- Operating lease contracts with non-cancellability feature
- Special purpose entities that you might need to include in consolidation (look to IFRS 12 for guidance)
- Sale and repurchase contracts
- Sale and leaseback contracts
- Factoring of receivables
- Any contract with embedded derivative features

Mistake #2

Not splitting the non-current liabilities

Standard IAS 1 requires us to show **non-current** assets and liabilities **separately from current** assets and liabilities.

Current items are basically those that fall due within 12 months after the end of the reporting period. Non-current ones fall due beyond 12 months.

It seems easy, so why is there so many companies getting it wrong?

Well, while it is quite simple to distinguish current debt from long-term debt, or current asset like trade receivables from non-current asset like long-term investments, there are some items **not apparent** at the first moment.

For example, a company might take some debt repayable in installments – like bank loan or even lease commitment.

Or, a company might face some liabilities for removing the asset and restoring the site after the end of its useful life.

In all these examples, a company has 1 liability in fact. However, as a part of this liability is due within 12 months after the reporting period, and another part is due beyond these 12 months, the liability needs to be split into its current and non-current portion.

How to avoid this mistake:

While you're preparing year-end closing, review all your liabilities and assess whether the company settles them in portions or installments, or whether they are to be settled as one-off payment.

To give you a hint, here are several examples of liabilities potentially hiding both current and non-current portion:

- Provision for employee benefits (focus on retirement benefits)
- Asset removal obligations, or liabilities for decommissioning, restoration and similar (especially when decommissioning takes place over period longer than 1 year)
- Finance lease liabilities
- Bank and other loans
- Liabilities from issued debentures or bonds

Hint: your deferred tax asset or deferred tax liability are always non-current items.

Mistake #3

Failing to report transactions between related parties

I can say from my own experience that related parties are the most popular part in the whole financial statements!

Transactions between them are so sensitive that separate standard **IAS 24** was issued to guide us in this field.

Regulators, tax guys and many small investors often pick up on them. Yet incorrect related party disclosures are one of the top ten IFRS mistakes.

Why?

Because companies forget who related parties are!

And as a result, they don't disclose the **bonuses to key management** personnel.

However I must admit that some companies do it intentionally, mainly after lots of scandals related to loss-making companies with really dazzling remuneration paid to their directors.

How to avoid this mistake:

Make a list of your related parties and don't forget to include all members of key management.

Make sure you disclose all kinds of compensations to key management, including share-based payments, bonuses, severance payments and other employee benefits.

Mistake #4

Incorrect estimates of PPE's useful lives

This is probably the biggest mistake related to property, plant and equipment and so many companies make it!

What's going on?

When a company buys some piece of property, plant and equipment, management has to decide how long the company is going to use the asset – or what is the useful life of the asset.

Useful life is an estimate or judgment based on what management thinks the company's needs are going to be. And sometimes, this estimate or judgment proves to be wrong.

If you spot the following situation in your company's accounts, then the useful lives are almost for sure incorrectly estimated:

- You have too many items of PPE that are still being used, but have been fully depreciated and as a result, they are carried at nil.
- Company realized too big profits or losses on sale of property, plant and equipment.
- Company's buildings are depreciated while their fair value goes up in fact.

How to avoid this mistake:

Standard IAS 16 requires reviewing and revising PPE's estimated useful life at the end of each reporting period.

So as a part of this annual review, look to your register of property, plant and equipment and search for items still in use but at nil value.

Mistake #5

Messing up changes in accounting policy with changes in accounting estimates

If you decide to change something in the usual way of preparing your IFRS financial statements, then watch out.

It is crucial to determine correctly whether you change an accounting policy or an accounting estimate.

Why?

The reason is that the accounting treatment of these 2 is totally different and if you don't classify the change correctly, your IFRS financial statements might contain serious errors.

You apply **changes in accounting policy retrospectively** – you must go back. It means that you apply the new accounting policy as if it had always been used, so you need to adjust your opening retained earnings.

As opposed to that, you apply **changes in accounting estimates prospectively** - you don't go back. It means you calculate the amount of change and include it in profit or loss either in the current period, or both in the current and future periods depending on whether the change affects only current or also future periods.



Many companies mess things up and just don't know whether they deal with an accounting estimate or an accounting policy.

As a result, some things are incorrectly booked to equity instead of profit or loss and vice versa.

How to avoid this mistake:

When dealing with changes in accounting estimates or policies, just think about what you're doing. If you change one of the following:

- **measurement bases** (for example, switching from FIFO to weighted average),
- **presentation criteria** (for example, deciding to offset assets and liabilities where permitted) or
- **recognition criteria** (for example, changing the materiality levels for recognizing non-current assets),

Then you change an accounting policy and you need to recognize it retrospectively.

If you change anything else (for example, useful life of PPE, or discount rates for calculating value in use), then you deal with the change in accounting estimate and you need to recognize it prospectively.

Mistake #6

Improper application of hedge accounting

Hedging against various risks became very popular over the last decade and companies started to utilize lots of derivatives as hedging instruments.

The problem with derivatives is that they are very volatile. In another words – you can easily reach big gains and suddenly big losses from derivatives.

Therefore, IFRS allow showing these gains or losses from derivatives and also other hedging instruments directly to equity (other comprehensive income) and not to profit or loss, but only if the **hedging relationship** is:

- Formally designated and documented
- Expected to be highly effective
- Assessed on an ongoing basis and determined to have been highly effective.

These conditions are quite strict and many companies don't fulfill them.

Despite this fact, they hide gains or losses from derivatives directly to equity instead of showing them to profit or loss.

As a result, the profit or loss is less volatile than it should have been and shareholders don't directly see the impact of derivatives on the annual profit or loss – **that's too bad**.

Why don't these companies meet the conditions for hedge accounting?

Because they think that merely saying “we took this currency forward in order to protect us against potential currency losses from foreign receivables” is sufficient for hedge accounting.

It is not!

As a result you might be accounting for hedge while you don't meet the conditions.

How to avoid this mistake:

The biggest pitfall here is to **document hedging relationship**. Take a paper and write down:

- What are your risk management objectives?
- What strategy are you taking in order to avoid the risks?
- What items expose your company to risks (hedged item)?
- How are you hedging against that risk (hedging instrument)?
- What is the nature of risks that you hedge against?
- How and when are you going to measure hedge effectiveness?

Once you have documented hedging relationship, don't forget to **assess** it regularly.

Mistake #7

Omitting the deferred tax from IFRS adjustments

Many companies maintain bookkeeping and prepare financial statements under their local accounting principles (GAAP).

And only then they take local GAAP accounts as a basis, make a bridge with IFRS adjustments and prepare IFRS financial statements for various purposes.

What are **IFRS adjustments**?

They are all accounting entries that clear the differences between local GAAP financial statements and IFRS financial statements.

For example, let's say you can capitalize start-up expenses as intangible asset under your local GAAP, but you cannot do so under IFRS. Therefore, you need to make IFRS adjustment in which you eliminate capitalized start-up expenses and related accumulated amortization.

The problem is that when preparing a bridge between local GAAP and IFRS, accountants forget to calculate and book deferred tax from IFRS adjustments.

Why is it so important?

Well, **deferred tax** is an accounting measure to close the gap between differing tax rules and accounting rules.

If you recognize deferred tax resulting from different tax bases and carrying amounts of assets and liabilities under the local GAAP, you don't automatically close the gap between differing tax rules and IFRS rules, do you?

As a result, your income tax expense/income and deferred tax asset/liability are misstated.

How to avoid this mistake:

Calculate your IFRS deferred tax **after all** other IFRS adjustments are recognized. Thus you'll make sure that everything is included.

$$\boxed{\begin{array}{c} \text{IFRS} \\ \text{DEFERRED TAX} \end{array}} = \boxed{\begin{array}{c} \text{Local GAAP} \\ \text{deferred tax} \end{array}} + \boxed{\begin{array}{c} \text{Deferred tax} \\ \text{from IFRS adjustments} \end{array}}$$

About IFRSbox

Who is behind

My name is Silvia, I'm FCCA with more than 15 years of professional experience. I created IFRSbox in order to make IFRS easier to learn.

My articles, videos, excel spreadsheets and courses were created to help you understand IFRS, and also help you in your job and also pass the IFRS test.

One of my readers wrote a comment: "Great. Simple. Clear. Useful!" My courses will help unlock your confusion.

My Beliefs

I believe that IFRS is too complex. Too many rules, too many exceptions and too many cross references to something.

This guide and my courses were created to help you look at IFRS in a different way. They make IFRS more digestible and allow you to remember the essential rules by illustrating and showing the examples from a real life so that you can put it easily into work or pass the exam.

Course I've Created to Help You

The **IFRS Kit** is an online course that brings your IFRS knowledge to a professional level. The course material unlocks the confusion and makes the material easy to understand and apply. Whether you are studying to pass the exam or you need to prepare IFRS financial statements in your work, IFRS Kit teaches you everything from the basics to advanced level practices. The material shows you the real life situations, complications and their step-by-step solutions. As a bonus you can download all excel spreadsheets and other materials attached for your further reference.

IFRS Kit: <http://www.ifrsbox.com/ifrs-kit>

Of course if you have any questions please let me know. I'm a big believer in making sure you are 100% happy with the materials that I've created to understand all the ins and outs of IFRS.

Thanks,

Silvia of IFRSbox